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General Business Conditions

THE business situation at the close of 1947, by all the customary measures, is one of extraordinary strength and activity. The productive facilities of the country are being called on not only to satisfy the greatest demand for consumer goods ever known, but also to supply the materials, labor and equipment to modernize and expand industries and improve utilities and public services. They are being asked to increase vastly the supply of housing, and to help feed western Europe and assist in its economic reconstruction. They are asked to do all these things at the same time. This is a tremendous conjunction of demands, and in the aggregate it is more than the country can satisfy, as rising prices show.

To meet these needs the industries are doing all they can within the limits of their facilities and the supply of materials and labor. They are employing more people than they did in wartime and are turning out vastly more goods and services than ever before in peacetime. Industrial output in 1947 has exceeded 1946 by 9 per cent and 1939 by no less than 73 per cent, according to the Federal Reserve Board's index. Despite an impression that trade during 1947 has expanded only in dollars and not in units (which is the case in some lines), the record-breaking production may be taken as evidence that the physical volume of goods moving, in the aggregate, is also record-breaking. In real as well as money terms, the country has never been so busy or had so much to enjoy.

Where dollar measurements are used, current figures are substantially higher than even during the war. The value of production at the year-end is running 9 per cent, money incomes 19 per cent, and the value of trade (consumers' expenditures) 36 per cent above the highest wartime year. As compared with 1946, the increase in each case is approximately 15 per cent.

"1947 Recession" Failed to Appear

At this time last year many people doubted that 1947 could run its course without recession in business. They believed that rising costs and prices would drive buyers out of the markets and check construction. They were afraid of the inventory situation, and of the prevalence of labor troubles and low productivity. They expected declines in exports and farm prices. These apprehensions were strengthened by the decline in the stock market in the Autumn of 1946, which seemed to foreshadow recession.

In fact, merchandising trades and the industries supplying them had to make adjustments, to get commitments in order and clear out inferior wartime goods. Expenditures on high-priced luxuries have declined, and in an increasing number of lines competition has become stiffer. This change in conditions has not been entirely painless. What the pessimists over-

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looked, however, was that such adjustments exert little effect on the general situation if employment and buying power are otherwise sustained. Purchasing power for the output of consumers' goods industries has been held up not only by their own activity and the farm prosperity, but by employment and buying power flowing from the programs of plant improvement and expansion, construction activity, and the export demand. Against the strength in these sectors, the readjustments have weighed lightly.

For a time in the Spring resistance to prices and particularly to the cost of construction was marked. During the second half year, however, this resistance has waned. Inflationary forces have taken control again and the price rise has been resumed. Possibly people became accustomed to the high prices and accepted them more readily for that reason, but there were other contributing influences. The most fundamental, which gradually asserted itself, was the strength and liquidity of the financial situation. Consumers had money and wanted goods, and business men had money and wanted to expand and modernize. Both had liquid assets and both had access to credit at attractive rates.

Also, new developments had a good deal to do with overcoming the temporary hesitation. One was the decline in the corn crop in this country and in the wheat crop in Europe, which brought a rapid rise in food prices and weakened hopes for a stable or declining price level. Another was the development of the Marshall program, which raised estimates of future exports. Still another was the "second" round of wage increases, starting another round of cost and price advances.

All these influences together have made the second half of 1947 look considerably different than the pessimists had expected. As expectations of price declines dwindled and fears of recession abated, business men generally have gone ahead with projects which they feel can pay out even at the high costs. Revived confidence has shown itself in forward buying. The usual spiraling effects of inflationary influences have been evident, with new wage demands following the price increases and with a further expansion in credit, necessary to carry on the enlarged volume of business at the higher prices.

The 1948 Outlook

Any inquiry into the outlook for 1948 should start with recognition of the momentum under which business is moving. The carryover of unfilled orders into 1948 is huge, and most industries seem to have before them an accumulated demand for all they can make for a considerable time to come. Premium prices for second-hand offerings of steel, which many buyers willingly pay rather than wait their turn at the mills, demonstrate the strength of the steel demand. In automobiles the position is the same. Recent awards of contracts for new construction have been unseasonally high, and in conjunction with the housing needs indicate that another big building year is in sight.

The public utilities are in the midst of an expansion program which is necessary to meet the demand for service and to restore a safe margin of reserve capacity, and the oil industry is in a similar position. The railroads urgently need equipment. Farmers urgently need machinery and have the means to buy it. On top of all this is the demand from abroad and the strong likelihood that the export surplus, while probably smaller than in 1947, will continue huge.

It is hardly conceivable that a general state of activity which is so strongly supported by demand for producers' goods at home and abroad can change much in the near future, for even if this demand should drop, the effects on production, employment and incomes would lag by a considerable time. The fear that price and income disparities would end the boom, through loss of purchasing power by groups whose incomes have risen less than prices, appears to have subsided somewhat. These disparities can be expected to make trouble when the situation is ready to turn for other causes. But on the showing of the past year the boom can run on despite them. The lesson of 1947 is that confidence in the maintenance of consumer expenditures at high levels is justified as long as sustained activity in durable goods and exports holds up the income totals.

Is the Money Running Out?

Over and against the foregoing considerations are others which have come very much to the front during the past month or two, and which should be kept constantly in view. Everyone recognizes that business is in an inflationary boom. The boom is financed in part by the creation of debt. The new questions which should enter calculations are two in number. First, will corporations continue willing to go into debt in order to carry out programs of capital expenditure at present high costs? Second, will capital and credit be forthcoming to finance the continuation of demand at present levels?

To the extent that borrowings are supplied out of current savings they do not increase the over-

all demand for goods, for the purchasing power acquired by the borrower is given up by the lender, who abstains from spending in order to save and invest the money. However, even though borrowings supplied out of savings do not add to the inflation it may be undesirable to carry them too far from the standpoint of prudent corporate management, which must keep an eye on the hazards of excessive debt in case conditions should change for the worse. In very many cases the ratio of debt to owners' capital has risen substantially. The opinion of most careful observers would be that the rise has not gone to the point of causing any general concern, but the tendency will bear watching, and it must be increasingly in the minds of both borrowers and lenders.

The second question is a related one. A year ago it was possible to say that the strength and liquidity of the financial situation was the most important of all the supporting influences against recession. The liquid assets — cash and short-term governments — held by corporations at the beginning of 1947 were still very large, and retained earnings and depreciation allowances supplied funds for capital programs. Although equity capital was difficult to raise throughout the year, corporations obtained more new money in 1947, through public bond offerings and from the insurance companies, than in any year since 1930. Where recourse was had to the banking system, the banks have had the resources and liquidity to take care of borrowers at attractive rates.

Capital Demand and Supply

The beginning of 1948, however, finds many corporations with smaller liquid assets and with heavier borrowings. They have a poor market in which to obtain new capital through sales of either common or preferred stocks, and the bond market is running against them, as the rising cost of borrowing shows. They will have in 1948 as in 1947 their retained earnings and depreciation allowances to draw upon for new projects, and will have access as always to the savings of individuals and institutions. The banking system is strong and liquid. But the banks are now carrying some $7 billion more loans than a year ago, and the Federal Reserve and Treasury authorities have made it clear that they believe the brakes should be put on further overall credit expansion. With tighter money and the threat of further moves by the authorities banks are much more cautious about term loans, and much more likely to reject the applications of marginal borrowers.

We reserve further discussion of the supply of savings and of bank credit policy for later pages of this Letter. The point to be made here, in relation to the general business outlook, is that by all signs capital needs will be harder to finance in 1948 than in 1947. How much harder will depend upon a variety of factors, including the willingness of people to save and the policies of the central banking authorities.

It is in these areas that the key to the duration of the inflation is probably to be found. Booms generally last until the money runs out, or until demands are satiated. In many categories — housing, automobiles, and many capital goods industries; and in exports, assuming a foreign aid program — the satiation point is plainly a considerable time away. But the boom is sure to stop if the money runs out, and that is why the developments in credit and the capital markets should be constantly in view.

Inflationary Pressures

Another element in the outlook for 1948 which ought to be watched and considered is the attitude of people toward the problems which the economy faces. It will be generally agreed that the industrial organization is under excessive pressure of demand. Our productive facilities cannot do everything that people are asking of them. Continuing pressure of demand, after full employment is reached, pushes up prices, raises costs and inflates capital values. It creates conditions under which waste, extravagance and inefficiency thrive and mistakes, miscalculations and speculative excesses develop. These elements of instability multiply as inflation proceeds. Such movements have always ended in reaction and depression. To make this time an exception, and to bring the balloon safely to earth before it bursts, will require the maximum of understanding, restraint and cooperation from everyone.

One of the statements most often made in this Letter during the long inflationary trend is that everyone has a stake in economic stability and everyone can contribute to it. Since the present need is to repress the excess of demand and so reduce the pressures on the markets, it is in order to ask what both people and government can do about it. People want more goods and more services, including government services. They also want more leisure, with higher pay. These objectives are not fundamentally irreconcilable over the long run, when both can be provided by technological progress and increased productivity. But progress requires capital, and capital is produced by working and saving. People would be better off in the end, and they would contribute immensely toward stabilization now,

if they would postpone buying some of the things they want now, save more, and add to the supply of capital which the industries are so eagerly seeking.

The industries should feel a similar responsibility. Their capital investments are contributing to the pressure exactly as consumer expenditures are contributing to it. While in the long run the country will benefit more by increasing and overhauling its productive machinery than by using the money for extravagant consumption, the problem is one of short-run congestion as well as long-run desirability. To relieve the congestion some people will have to give up something – to postpone satisfaction of some want or the execution of some project deemed desirable.

Rate of Saving Should Govern

If restraint is exercised, the things which people are now trying to do all at once can be done over a longer period, more efficiently, and at a lower real cost. The rate at which the rebuilding of industry, rehousing of people and all the other things we are trying to do are carried out should be governed by the rate of saving. It is the effort to do all these things faster than savings accumulate which results in recourse to credit. The rate at which credit is expanded should be governed by the rate of increase in production. Credit expansion faster than production can be enlarged is inflation. In essence, consumers and industries alike are trying to get through a gate all at once, and at a time when the passage is narrowed to make room for foreign aid. Anti-inflationary action requires standing in line, and easing the congestion.

Anti-inflationary action also requires exceptional political courage. It requires courage to reduce government spending, as for example, payments to farmers; to cut public works programs; or to recast the housing credit programs as Mr. Eccles suggested a few weeks ago. It would require political courage to aim tax policies directly at the repression of consumption – as would be the case if, for example, more excise and sales taxes were levied – instead of relying so largely upon progressive income tax rates, which act like a blunderbuss and in many cases repress saving more than they reduce consumption.

Inflation pressures will not be relieved, however, without both individuals and the Government doing things which are difficult and unpleasant. If this is understood and acted upon the prospect is for years of rebuilding and of progress in lifting living standards. But if we try to do the rebuilding at an excessive rate, and without sacrificing and saving to the extent necessary, the program will be carried out at terrific cost, not only in dollars and cents but in terms of boom and bust.

The outcome will depend both upon the decisions of people and upon the policies of the monetary authorities and the Government generally. The influences in the capital markets and in the credit situation which may repress demand as 1948 goes on have been mentioned, and are discussed more fully hereafter. The more restraint people show, the less need there will be for government to enforce restraint. The objective is to make 1948 a year of neither progressive inflation nor costly deflation, but of order and stability.

The Problem of Credit Control

During the past two months students of central banking have been treated to a liberal education in testimony before Congress by high government officials and bankers as to what should be done about the present credit situation. This discussion has centered mainly on three questions:

1. To what extent is the current expansion of bank credit responsible for inflation and rising prices.

2. To what extent are existing monetary and credit powers adequate for controlling further expansion of bank credit.

3. The merits and demerits of the request by the Board of Governors of the Federal Reserve System for additional powers to require commercial banks to carry, over and above present lawful reserves, supplementary reserves in cash and/or short-term government securities up to a maximum of 25 per cent against demand deposits and 10 per cent against time or savings deposits.

In the preceding issue of this Letter we reviewed testimony in November by Chairman Eccles of the Federal Reserve Board, and Secretary of the Treasury Snyder, and a statement by the Federal Advisory Council – the latter a statutory body composed of leading bankers from each of the twelve Federal Reserve districts who serve in an advisory capacity to the Reserve Board.

The testimony and statements by these authorities revealed a wide measure of agreement as well as important points of disagreement. As to agreement, despite some difference of emphasis

on the credit factor, there was general concurrence that (quoting the Reserve Board) "the basic causes of inflation lie primarily outside of the area of current monetary and banking developments". The root causes are found in wartime finance and the consequent huge expansion of purchasing power in the hands of the people.

Both Mr. Eccles and the Federal Advisory Council stressed the continuing high level of government expenditures, as well as the inflationary activities of government credit-insuring agencies, especially in the field of housing. Both cited the foreign aid program, world crop shortages, policies as to wages and working hours, and various other non-monetary factors. Both were in agreement that (again quoting the Reserve Board) "expansion in credit has to a large extent been necessary to supply working capital needed by business to maintain or increase production at rising prices."

Where the *main* difference appeared was not over the role of bank credit in present inflationary tendencies, nor even as to the need for putting the brakes on further overall credit expansion. Disagreement was largely as to methods of credit control. Mr. Eccles, speaking for the Reserve Board, took the position that the present powers are inadequate in that their effective use might imperil the government security market. Both Secretary Snyder and the Federal Advisory Council, on the other hand, held that the present powers were adequate, except that Secretary Snyder advocated a revival of Reserve Board control over instalment selling. Both the Secretary and the Council were in agreement in opposing the Board's special reserve proposal, the former on grounds that it would not achieve the ends expected, and the latter as impractical, inequitable, and a step towards socialization of banking.

The Debate Continued

During the past month, discussion of credit control measures has continued, with additional testimony and statements by Federal Reserve officials and private bankers, as well as moves by Congress, of significance in the development of credit policy. These included:

(a) Introduction into Congress by Chairman Wolcott of the House Banking and Currency Committee of a joint resolution to increase the reserve requirements of the Federal Reserve Banks from the present 25 per cent gold certificates to deposits and notes, to which they were reduced during the war, to the former 35 per cent against deposits and 40 per cent against notes.

(b) Renewed testimony by Mr. Eccles on behalf of the Reserve Board's special reserve proposals; and opposing testimony by Allan Sproul, President of the Federal Reserve Bank of New York, by Edward E. Brown, President of the Federal Advisory Council and of the First National Bank of Chicago, and by others.

(c) Statement by Mr. Eccles defining more clearly areas of agreement and disagreement between himself and Secretary Snyder.

On the matter of higher reserve requirements for the Federal Reserve Banks, Congressman Wolcott described the resolution as "an indication of the Congressional policy that there should be a tightening of credit." He explained further that it represented "the first phase of an attack against the easy money policy of the Administration which has contributed towards an inflationary high price spiral." The resolution, however, failed of adoption when the House defeated, under a rule forbidding amendment and requiring two-thirds approval, the first Republican sponsored anti-inflation program, and was not incorporated in subsequent legislation.

Mr. Eccles, in reappearing before Congressional committees, took pains to emphasize that the proposed special reserve for commercial banks "is only a part, though a necessary part, of any effective anti-inflationary program." Recognizing "a continuing, vigorous fiscal policy" to be "by far the most important action," he indicated that over the next four months the piling up of Treasury tax receipts and use of the money to retire bank-held government debt could be expected to restrain inflationary credit increases. But he warned of the danger of "an unbridled expansion of bank credit" after that period, and went on to present a point by point rejoinder to criticisms of the proposed special reserve plan for curbing expansion.

Mr. Brown, while agreeing with Mr. Eccles on some points – notably the need for continued high tax revenues and payments on the national debt – reaffirmed the Federal Advisory Council's position as to the adequacy of present credit control powers and opposition to the special reserve plan. Referring to suggestions that banker opposition to the reserve proposal was motivated by a selfish desire to see interest rates rise through withdrawal of support from the government bond market, he pointed out that "even if we were concerned with self-interest we have got more to lose by a sudden collapse and a severe recession." Denying that an unpegging of interest rates implied a removal of all control over government bond prices, he declared, "Neither I nor other

members of the Council have urged that the bonds be allowed to seek their own level. Personally, I think the bond market must be supported."

Testimony of Mr. Sproul

Testimony by Mr. Sproul, President of the Federal Reserve Bank of New York and Vice Chairman of the important Open Market Committee of the Federal Reserve System, opposing the new reserve plan, was particularly noteworthy as coming from a source not open to the charge of "having an axe to grind."

Observing that the current discussion over bank credit and prices appeared to have the makings of a chicken and egg argument, Mr. Sproul contended that "the current expansion of bank credit is more a result than a cause of advancing prices." Quoting at some length from the November Federal Reserve Bulletin on the factors in rising bank loans, he concluded that, except for consumer credit and mortgage credit, "this is a picture of an economy in which unusually high consumer spending . . . has been dependent only in a minor degree on the current expansion of bank credit."

He then cited changes in total demand deposits and currency owned by the public (including business, but excluding banks and the Federal Government) as follows:

June	1939 – $33	billion	
November	1945 – 106	"	(prior to Victory Loan)
December	1946 – 110	"	
November	1947 – 112	"	(estimated)

Even as the marginal factor, it would be difficult, he asserted, to account for much of the rise in prices during this past year on the basis of an increase of perhaps 2 per cent in demand deposits and currency. While it is true that bank loans increased by about $7 billion during the past year, this was offset by a decline in bank holdings of government securities through retirement out of surplus revenues.

As to the special reserve proposal, Mr. Sproul feared it would expose us to grave monetary and market disturbances while being put into effect, and that when in effect it would leave us in much the same dilemma we face now. The Federal Reserve System would probably be saddled with the onus of not having checked inflation, or of having caused deflation. Outlining further his objections, he said:

Unless that requirement (for a special reserve) is reduced to a point where it will exert little restraint on bank lending, we shall be faced with the probability of mass dumping of longer term government securities by deficient banks. Nor can it be expected that, in these circumstances, the banks which are deficient would be able to sell their government securities to nonbank investors, or that there might be some automatic exchange of holdings between banks which are deficient in reserves and banks which have a surplus. The System would have to meet a major threat to an already sensitive government securities market, by buying large amounts of government securities, thus putting more funds into a market we are trying to contract.

. . . Next we must take account of the $59 billion of marketable medium and long government securities held by nonbank investors. The fact is that the large institutional holders of these securities now have alternate uses for their funds – to purchase corporate bonds and to make mortgage loans and private placement loans, and that they have already become sellers of government securities which we are buying. If rates on long term private borrowing are further increased, the incentive to sell long term government securities will be increased, and we shall be the principal if not the only buyers. If nonbank holders sold large amounts of government securities, the System would be forced to absorb them and the volume of bank reserves would be greatly enlarged.

Area of Eccles-Snyder Agreement

While these Congressional hearings were going forward, Chairman Eccles and Secretary Snyder, whose opposing testimony on the special reserve proposal had caused some confusion as to government policy, had got together to iron out their differences. Following this conference, Mr. Eccles issued a statement defining their disagreement as "narrowing down to whether the special reserve would be appropriate if additional measures prove necessary to limit the now unrestricted access of the banking system to reserves upon which a multiple expansion of bank credit can be built."

The statement emphasized "full agreement" on nine points. Because of the high importance of these officials in the formulation of financial policy, the following brief summary is pertinent:

1. Vigorous fiscal policy to insure a large budgetary surplus is the most effective anti-inflationary measure.

2. The need to reverse the process which increased money supply during the war. This entails both budgetary savings and sale of savings bonds to reduce bank-held debt.

3. The program of the Treasury and the Federal Reserve Open Market Committee will be effective for the next few months due to the Treasury's expected substantial cash balance.

4. Additional restraint may be expected as a result of cautions issued by bank supervisory authorities.

5. Possibly stronger measures may be necessary when current debt-payment operations slack off.

6. The extent of such restraints will depend in part on the self-restraint of the banking community.

7. The special reserve proposal supplements, but does not supplant, the fiscal program and direct action on other

fronts where inflationary forces cannot be corrected by monetary and fiscal policy alone.

8. The 2½ per cent rate for long-term marketable governments must be maintained under present and prospective circumstances.

9. Restraints should be reinstated on instalment credit.

A Program Emerging

From all this batting back and forth of ideas the broad pattern of a monetary and fiscal program may be seen emerging along the following lines:

1. The special reserve proposal is shelved.

2. Inflation is to be fought in the financial field mainly by driving to increase sales of savings bonds, by continuing the retirement of inflationary bank-held government debt out of Treasury surpluses and proceeds of savings bond sales, and by permitting moderate advances in short-term interest rates.

3. The long-term rate for government credit is to be held at 2½ per cent.

4. Regulation W might be restored empowering the Federal Reserve Board to resume control of instalment credit.

Much of this program is now under way. Plans are being made for initiating a savings bond drive early this year. The Treasury is continuing its policy of using surplus revenues and funds from the sale of savings bonds to retire bank-held debt, with consequent extinguishment of bank deposits. During the past two months the Treasury has retired $600 million net of its 90-day Treasury bill maturities, most of which are held by bank investors, while the Federal Reserve Banks have tendered $340 million of maturing certificates for cash redemption.

This program of retiring bank-held debt is expected to be greatly accelerated during the first three months of 1948, when the tax revenues are expected to attain record-breaking proportions. From these revenues it has been estimated that the public debt may be cut down as much as $7 billion. This will be a deflationary factor to the extent that bank holdings of government securities and bank deposits are reduced thereby.

Short-term interest rates have been allowed to rise gradually, as indicated by an advance in the 90-day Treasury bill rate from ⅜ of 1 per cent last Summer to 0.95 per cent today, and in the 1-year certificate rate from ⅞ of 1 per cent in July to 1⅛ per cent on the latest issue dated January 1.

Accompanying this firming in open-market rates, Chairman Eccles in the course of his testimony stated that the Federal Reserve discount rate would be advanced from 1 to 1¼ per cent in the "not too distant future". This would have the effect of discouraging member banks from borrowing from the Federal Reserve Banks against short-term governments.

Action of the Government Bond Market

Quite overshadowing these moves, however, have been the dramatic developments in the government bond market. While the Treasury and the Reserve Banks have continued their oft-affirmed policy of supporting prices at levels that would maintain the long-term 2½ per cent rate, that policy has been taking some severe bumps not altogether unprecedented in the history of pegged markets.

Basic factors in the rather abrupt shift in the market last Autumn, from a condition requiring official selling of long-term Treasuries to keep prices from *rising* to a condition requiring official support to keep them from falling, are described in the following article on "Savings and Capital Expenditures". Suffice it to say here that, while some shaving of high premium prices was viewed by the authorities at first with unconcern, and even approval, the decline by the middle of November had gone far enough to call for official support to "stabilize" the market at selected points where par levels were being approached. For example, the Victory Loan 2½s of December 1967-72 were held at 101 and the 2¼s of 1959-62 at 100½.

At these levels the authorities "held the line" for some six weeks, and broadened the area of their support beginning December 3 to help restore confidence. But this was only at the cost of increasingly heavy purchases of long-term governments by the Federal Reserve Banks, both for their own account and for account of Treasury agencies and trust funds. Selling, instead of drying up with the appearance of official support, increased in volume as investors, nervous over the trend of interest rates and the fact that the Reserve Banks appeared as reluctant rather than willing buyers, made haste to get through the gate while it was still being held open. In the prevailing psychology, the more the authorities bought the more they had to buy, as the very magnitude of support operations tended to disturb rather than reassure investors, and hence to promote more selling, in a vicious circle.

In the six weeks ended December 24 the Federal Reserve Banks and Treasury investment accounts evidently acquired over $1.8 billion longer-term Treasury bonds, with heaviest purchases coming in the weeks of the 17th and 24th

as indicated by the first three columns of the accompanying table.

Indicated Official Government Security Stabilizing Operations
(Millions of Dollars)

Week ended		For Treasury investment accounts*	Change in Fed. Res. holdings of bonds over 5 yrs. to maturity	Total support for long-term governments	Change in Fed. Res. holdings of governments under 5 yrs.	Change in total Fed. Res. holdings
Nov.	19	0	+ 43	+ 43	+127	+170
	26	+109	+120	+229	—103	+ 17
Dec.	3	+157	+131	+288	—250	—119
	10	+ 81	+123	+204	—258	—135
	17	+285	+181	+466	—509	—328
	24	+255	+297	+552	— 54	+243
Total for weeks		+887	+895	+1,782	—1,047	—152

*For Old-age insurance and Unemployment trust funds and Postal Savings System as deduced from the Treasury daily statements through December 24.

That all this was working towards some kind of a climax was becoming increasingly apparent, when, on the 24th, the Federal Reserve Banks suddenly lowered their support price for the key Victory 2½s from 101 to 100¼, with still sharper markdowns in support prices for fully taxable issues eligible for bank investment. The next table compares old and new support prices (bold-face type) and open market prices last Summer before the decline started.

Treasury Bond Prices
(Dealers' Closing Bid Quotations)

	Aug. 31	Nov. 12	Dec. 3	Dec. 24
1½s of Dec. 1950	101	**100½**	**100½**	**100⅛**
2s of Dec. 1952-54	103⅛	102 1/16	**101⅞**	**101⅛**
2¼s of Sept. 1956-59	105⅝	103 15/16	**103⅜**	**101¼**
2¼s of June 1959-62*	102 9/16	**100½**	**100½**	**100**
2¾s of Dec. 1960-65**	115⅛	112 15/16	**111 15/16**	**109¼**
2½s of Sept. 1967-72	106 9/16	104¾	**103¼**	**101**
2½s of Dec. 1967-72*	102 15/16	**101**	**101**	**100¼**

* Restricted as to commercial bank ownership. ** Partially tax-exempt.

Note: Bold-face figures show support prices as indicated by rigid stability of dealers' quotations from day to day. The support levels which came into evidence December 3 were subject to minor adjustments in some cases prior to the Christmas Eve break.

The Crucial Question

As we go to press, the crucial question in the minds of investors is whether, at the greatly reduced premiums, the government bond market now rests upon a firm enough footing to be fully responsive to official support, or whether the markdowns that have occurred are but one step in a more far-reaching readjustment of the interest rate structure.

There is no doubt that the lower the prices at which stabilization operations are undertaken, the greater the chances of their success. With the decline in prices that has taken place, many bond accounts already have gone from black to red; this means a reluctance on the part of many such investors to sell and take their losses, thus tending to relieve pressure upon the market.

There is no doubt, also, that the Federal Reserve Banks and Treasury have powerful resources at their command for supporting the market. The difficulty, however, is two-fold, (a) the possible cumulative weight of persistent and widespread investor liquidation, and (b) the fact that large scale purchases of government securities by the Reserve Banks mean putting more funds into the market and creating fresh deposits and purchasing power at a time when the overall policy is directed towards contraction.

As to (b), it is true that over the past six weeks the heavy pumping out of Federal Reserve credit in support of the long-term market has not aggravated general inflationary tendencies. As shown by the fourth and fifth columns of the table on government security stabilizing operations, Federal Reserve purchases of long-term governments have been somewhat more than offset by the sale or redemption of securities of under 5-year maturity.

This balancing-off is likely to continue through the first quarter of this year, when the anticipated heavy debt retirement can be expected to keep pulling down Federal Reserve holdings of short-term governments. But it can hardly be expected to continue indefinitely. Providing business demands for credit keep up, continued Federal Reserve support of the bond market on a substantial scale at fixed prices would seem bound to lead, sooner or later, to an enlargement in total Federal Reserve credit in use, with inflationary results.

How Effective the Overall Program?

Viewed in the light of these recent developments, how effective is the program outlined by the authorities for restraining credit expansion likely to be?

The answer is, of course, that no one can tell as yet. There is, however, reason to believe that the steps already taken, together with the repercussions in the bond market, are having an effect much greater than people generally realize. The drop in bond prices and the related rise in interest rates have served corrective purposes. The cost of borrowing has been increased and, correspondingly, the returns available from the investment of new savings. The rise in short-term interest rates at the same time has eased the

pressure on banks to shift out of shorter-term government securities in order to obtain more adequate rates of return on their resources.

The bond price drop has wiped out hundreds of million of dollars of paper profits on the books of financial institutions. However, since bank holdings of bonds are mostly governments and other high-grade issues, largely short-term, the decline itself does not seriously affect the capital position of the average bank despite the loss of paper profits unless or until the depreciated securities have to be sold. The government securities will be paid when they mature or are called, and any price above par at which they are carried on the books will by the call date be fully amortized. In accordance with the accounting practices prescribed by the Comptroller of the Currency and the Federal Reserve System, market appreciation is not considered a profit or market depreciation a loss. If the bank's position requires the sale of any of these bonds to raise funds to meet withdrawals or to take care of legitimate demands of customers, the market depreciation becomes a real loss to that bank in making the sale. Many banks, of course, hold adequate amounts of short-term securities to meet probable demands without selling their longer-term issues.

Nevertheless, these developments, plus the fact that the authorities have vast power to apply further braking on credit expansion as the need arises, have made banks very much more cautious in making intermediate-term capital loans. Many banks feel that they have all the term loans they want. Insurance companies are being more "choosy". Except in the area of real estate loans covered by government guarantees, loans to marginal borrowers are likely to be pushed back. Ratios of debt to equity are being scrutinized more closely. Borrowers are being asked more often to pare down their requirements, and some programs for capital outlays have been held in abeyance. At the same time government credit-granting agencies have been instructed to hold their operations to a minimum.

All this shows that the present powers are effective, and that what is needed is not additional powers but willingness to use those already at hand.

Savings and Capital Expenditures

One of the points made in the President's message to the Congress when it reconvened in November was the need for increased saving by the public generally. "Every dollar that is saved instead of spent is a dollar fighting against inflation," the President stated. The principle is especially important at this time in meeting demands for capital. Saving, through the accustomed investment channels, makes money available for capital expenditures – for purchase of tools and machinery, for constructing new factories, roads, and schools, for building homes and apartments, for putting more motive power and freight cars on the railways, for relieving shortages in electric generating and telephone facilities, and so on down the long list of capital needs.

The aggregate demands are enormous. They have been running beyond the current flow of savings made available for financing capital expenditures through insurance companies and other savings institutions and thus have been spilling over into credit expansion.

Capital Expenditures by Business

To see why capital outlay programs have been tending to cause credit expansion requires an analysis of the supply and demand for current saving. Department of Commerce data indicate that business expenditures for producers' durable equipment, and industrial, commercial and public utility construction, have recently been running between $20 and $25 billion a year, a rate beyond any precedent. The financial requirements are covered to the extent of more than two-thirds out of internal reserves, principally current charges to depreciation accounts, and reinvested earnings. But these are far from adequate to fill the whole bill. With the sharply advanced price levels, current depreciation charges cannot take care of much more than half the funds needed simply to replace facilities as they wear out and are replaced.

The first result has been gradual exhaustion of much of the liquid resources accumulated during the war. These resources were drawn on heavily in the early postwar period, to liquidate tax liabilities, to meet costs of reconversion, and to pay for initial capital outlay programs. The next recourse was to borrowing from banks and insurance companies and new capital issues in the market. Some corporations that have been out of debt since the early '20s have found it necessary in recent months to borrow at their banks.

The following table, based on estimates of the Securities and Exchange Commission, shows how working capital positions of nonfinancial corporations were changed over the two years ended June 30, 1947. Cash and government securities

were cut down by more than $10 billion while amounts necessary to carry inventories and accounts and notes receivable increased an estimated $19 billion. The indicated rise of $4½ billion in accounts and notes payable includes short-term borrowings from banks to cover increased working capital needs while the $11 billion growth in net working capital reflects primarily an absorption of reinvested earnings for covering increased working capital needs.

Current Assets and Liabilities, All Corporations Excluding banks and insurance companies

(Billions of Dollars)

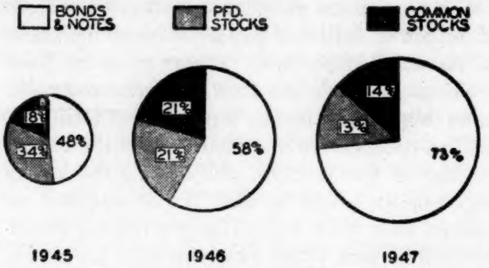
Current Assets	June 30, 1945	June 30, 1947	Change
Cash on hand and in banks	$23.0	21.8	— 1.2
U. S. Government securities	22.4	18.0	— 9.4
Accounts and notes receivable	25.6	32.0	+ 6.4
Inventories	26.3	39.1	+12.8
Other current assets	1.4	1.5	+ 0.1
Total current assets	98.7	107.5	+ 8.8
Current Liabilities			
Accounts and notes payable	25.1	29.5	+ 4.4
Federal income tax liabilities	16.7	8.7	— 8.0
Other current liabilities	8.3	9.4	+ 1.1
Total current liabilities	50.1	47.6	— 2.5
Net Working Capital	48.6	59.8	+11.2

Source: Securities and Exchange Commission. Figures are rounded and will not necessarily add to the totals shown.

Corporate demands for additional long-term capital are manifested in the increased stream of security issues for the purpose of raising new capital. Tabulations of the Commercial and Financial Chronicle show a rise from $1¼ billion in "new money" issues of corporate stocks and bonds in 1945 to $3½ billion in 1946 and $3¾ billion in the first eleven months of 1947. A record total for December is indicated, putting the 1947 total up to about $4½ billion.

The accompanying "pie" chart reveals, in the comparative areas of the circles, the growth in the volume of corporate security issues for purposes of raising new capital. The subdivisions of the circles indicate the proportions raised through sales of bonds and notes, preferred stocks, and common stocks. Here the tendency to rely on borrowing – through sales of debt obligations – for the bulk of new money requirements is striking.

Business needs for additional capital comprise only one vital sector of the overall demand for savings. Another large sector is residential construction which, encouraged by easy terms and low interest rates, is on a strong rise despite high costs. The Department of Commerce has estimated that expenditures for urban residential construction in the third quarter of 1947 approached a $5 billion a year rate.



Corporate Security Issues for Purposes of Raising New Capital.

Source: Tabulations of the Commercial and Financial Chronicle except for December, 1947 which is estimated.

At the same time State and local Governments, which reduced their debts during the war years, are again borrowers, at a net rate of about $1½ billion a year, and are beginning to dip into their postwar reserves. In still another field is the European Recovery Program which will involve a shift to private lending channels, through the International Bank or directly, if European countries are to reestablish their creditworthiness and the American taxpayer is to be relieved of a heavy burden.

The Supply of Savings

Apart from internal resources available to business for financing capital outlays, estimated by the Department of Commerce at $16 billion in 1946 with a somewhat higher figure indicated for 1947, the chief burden of financing long-term capital requirements falls on life insurance companies and other savings institutions through which individual saving is today so largely canalized. With net additions to resources running at a rate of $7 or $8 billion a year (for life insurance companies, mutual savings banks, savings departments of commercial banks, and building and loan associations) the supplies of funds are substantial but not inexhaustible. While industry was carrying on mainly through the use of liquid resources accumulated during the war, and before building activity swung upwards, these institutions found it difficult to find sufficient outlets for their currently accumulating funds. The change in the situation this year is brought out in the following table, drawn from the Treasury Bulletin, covering changes in government security portfolios of major life insurance companies and mutual savings banks during 1946 and the first nine months of 1947.

Government Security Portfolios

(Billions of Dollars)

	Reported Holdings Dec. 31, 1945	Dec. 31, 1946	Sept. 30, 1947	Changes Year 1946	First 9 mos. 1947
Life Insurance Companies					
Treasury bills, certificates and notes	0.6	0.7	0.1	+0.1	—0.6
Bank-eligible bonds*	4.8	4.0	3.4	—0.8	—0.6
Bank-restricted bonds*	15.0	16.7	16.8	+1.7	+0.1
	20.4	21.4	20.3	+1.0	—1.1
Mutual Savings Banks					
Treasury bills, certificates and notes	0.3	0.5	0.4	+0.2	—0.1
Bank-eligible bonds*	4.1	3.1	2.8	—1.0	—0.3
Bank-restricted bonds*	6.1	7.9	8.6	+1.8	+0.7
	10.5	11.5	11.8	+1.0	+0.3

*Based on current eligibility status.

Source: Treasury Survey of Ownership of Securities Issued by the United States as reported in the Treasury Bulletin. The banks and insurance companies covered in the survey account for approximately 95 per cent of the amount of such securities owned by all banks and insurance companies in the United States.

During 1946 these institutions added substantially to their holdings of restricted bonds – the long-term War Loan drive issues which commercial banks are not eligible to buy – partly by the use of new accruals of funds and partly by the use of proceeds from the sale of shorter-term bonds not restricted as to bank ownership. Temporary investments in short-term government paper – principally Treasury certificates and notes – rose to unusually high levels. In 1947, heavy demands for mortgage money and funds to finance public utility and industrial expansion not only absorbed all of their fresh accruals of funds but took up the slack represented in temporary investments and required substantial net sales from government bond holdings.

With mutual savings banks the changes have been less marked than with insurance companies but the directions of change are the same.

Shortage of Saving

The problem is thus posed of providing an adequate supply of savings to finance vast capital outlays. The individual who holds his savings bonds, or buys more, makes a contribution by holding potential purchasing power off the market. Provisions for the future through life insurance and saving accounts make substantial funds available for capital outlays. Substantial business profits, combined with conservative dividend policies pursued by corporations, are another major resource. But these are not enough.

There are at least three major points of actual or potential danger. First, there is the tendency to consider profits "exorbitant" and to demand that some of them should be shifted into the hands of wage-earners. This view, one that appears to have been given weight in the Second Annual Report of the Council of Economic Advisers released to the press December 23, would, if carried through, at once curtail the only big supply of risk capital and the incentives to carry through capital expenditure programs. Quite clearly, it would throw the economy off balance in the essential matter of providing new and better tools for men to work with. Even when such views are expressed simply for wage bargaining purposes or for political consumption, they can do harm by impairing the investor's confidence.

Secondly, easy terms on home-building and buying, with government guarantees, weaken the stimulus to saving for home ownership. While the complete picture is not available, estimates prepared by the Securities and Exchange Commission suggest that mortgages are being placed on new and existing homes at an entirely unprecedented rate. This puts an excessive strain on the supply of mortgage money and spells difficulties for the buyer, foreclosures, and losses for the Government at some future time.

Thirdly, the supply of equity capital to corporations through new common stock issues is obstructed by a system of individual income taxation expressly designed, during the '30s, to discourage saving and encourage consumption expenditures. These effects have become much more severe with the wartime tax rate increases and the rise in price levels.

Even if all sources of funds for capital expenditure were more open than they are, there is a question, as suggested earlier in this Letter, whether all programs could be taken care of at once on the desired scales. The need is for holding back some parts of these programs, especially where they require resort to borrowed money.

THE NATIONAL CITY BANK OF NEW YORK

THE NATIONAL CITY BANK OF NEW YORK

***Head Office:* 55 Wall Street, New York**

Condensed Statement of Condition as of December 31, 1947

Including Domestic and Foreign Branches

ASSETS

Cash and Due from Banks		$1,443,283,802.54
United States Government Obligations (Direct or Fully Guaranteed)		2,131,035,233.67
Obligations of Other Federal Agencies		28,214,818.55
State and Municipal Securities		231,062,937.10
Other Securities		80,775,281.37
Loans, Discounts, and Bankers' Acceptances		1,215,660,245.15
Real Estate Loans and Securities		2,819,262.64
Customers' Liability for Acceptances		22,309,380.78
Stock in Federal Reserve Bank		7,200,000.00
Ownership of International Banking Corporation		7,000,000.00
Bank Premises		28,491,252.22
Items in Transit with Branches		2,977,703.78
Other Assets		2,454,110.29
Total		$5,203,284,028.09

LIABILITIES

Deposits		$4,874,418,234.40
(Includes U. S. War Loan Deposit $23,605,479.44)		
Liability on Acceptances and Bills	$ 33,460,941.47	
Less: Own Acceptances in Portfolio	8,427,813.35	25,033,128.12
Reserves for:		
Unearned Discount and Other Unearned Income		5,673,264.16
Interest, Taxes, Other Accrued Expenses, etc.		23,393,787.62
Dividend		4,650,000.00
Capital	$ 77,500,000.00	
Surplus	162,500,000.00	
Undivided Profits	30,115,613.79	270,115,613.79
Total		$5,203,284,028.09

Figures of Foreign Branches are as of December 23, 1947

$251,123,478.00 of United States Government Obligations and $3,330,105.00 of other assets are deposited to secure $207,922,739.07 of Public and Trust Deposits and for other purposes required or permitted by law.

Member Federal Deposit Insurance Corporation

CITY BANK FARMERS TRUST COMPANY

***Head Office:* 22 William Street, New York**

Condensed Statement of Condition as of December 31, 1947

ASSETS

Cash and Due from Banks		$ 26,526,044.30
United States Government Obligations (Direct or Fully Guaranteed)		109,009,850.51
Obligations of Other Federal Agencies		1,077,404.61
State and Municipal Securities		5,412,048.50
Other Securities		101,037.50
Loans and Advances		1,209,888.42
Real Estate Loans and Securities		1,206,017.65
Stock in Federal Reserve Bank		600,000.00
Bank Premises		3,131,463.29
Other Real Estate		114,500.35
Other Assets		2,459,210.80
Total		$150,847,465.93

LIABILITIES

Deposits		$118,155,374.01
(Includes U. S. War Loan Deposit $2,092,739.02)		
Reserves		4,076,164.56
(Includes Reserve for Dividend of $310,621.20)		
Capital	$10,000,000.00	
Surplus	10,000,000.00	
Undivided Profits	8,615,927.36	28,615,927.36
Total		$150,847,465.93

$7,847,838.59 of United States Government Obligations are deposited to secure the United States War Loan Deposit and for other purposes required or permitted by law.

Member Federal Deposit Insurance Corporation

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